The New Era Of Climate Risk Disclosure

by Kathy Nieland, Catherine Bromilow and Matt Arnold

In February of this year, the U.S. Securities and Exchange Commission made clear in no uncertain terms that corporations have a duty to disclose risks faced through potential climate change. Yet many boards remain unaware of what constitutes a "material" climate risk, or just how broad the scope and potential impact truly are.

With the global financial crisis fading, corporate boards and management teams are turning their attention to growth. As part of this shift in focus, they are revisiting emerging risks to assess potential impacts on their companies' prospects. For some business leaders, the risks and opportunities related to energy and climate policy are becoming a significant part of this picture. Increasingly, stakeholders demand more information about the climate-related risks confronting companies—and the strategies management has or will put in place to respond.

The recent SEC guidance does not impose any new climate disclosure rules. However, they raise awareness of the *type* of risks that could be considered material.

The SEC has recognized these concerns and in February 2010 issued interpretive guidance explaining how companies can disclose climate risks material to them. This action gives greater prominence to these disclosures starting in the 2010 proxy season.

The SEC guidance does not impose any new or modified legal requirements. Under existing rules, companies already had to disclose material risks such as new environmental litigation that could significantly impact their financial position and results of operations.

However, the SEC does raise awareness of the types of risks that could be material and warrant disclosure. In its guidance, the SEC takes a rather broad view of climate-related risk. It describes the obvious risks (such as direct consequences from existing or pending legislation or regulations restricting greenhouse gas emissions), but then goes on to ask companies to consider other risks, including:

- ☐ Potential impacts from international accords and treaties related to climate change.
- ☐ The indirect consequences of climate change regulation. For example, increased demand for goods that result in lower greenhouse gas emissions than competing products, which may lead to decreased demand for the company's products or services.
- ☐ Damage to corporations'—and even to customers'—assets or supply chains caused by floods, droughts, and other severe-weather events.

The SEC commissioners' vote was split three to two on issuing the guidance—a sign of their differing views. In an acknowledgment of current political sensitivities, the SEC chairman said it intended the guidance to be neither a statement on whether the world's climate is changing nor (if it is changing) a statement on what causes those changes. Instead, the SEC stressed that the purpose of the guidance was to ensure companies apply disclosure rules consistently.

It is clear investors will be intensely interested in seeing what companies disclose in reaction to the new SEC guidance. Many investors have been asking for more disclosure, placing shareholder resolutions in proxy statements. It is not just electric power generators and oil and gas companies that investors are targeting either: they are also seeking action from builders, retailers and financial services companies. At the time of this writing, shareholders have lodged a record 89 climate-related resolutions with U. S.

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companies in 2010, according to Ceres's Investor Network on Climate Risk.

Aside from shareholder resolutions, research suggests that climate change is also top of mind for many business leaders. More than half of the 100 U.S. chief executives surveyed by PricewaterhouseCoopers say they expect consumers will place heavier emphasis on companies' environmental and corporate responsibility practices before they make purchases. In the same survey, 48 percent of U.S. CEOs agree that a company's response to climate change will create a reputational advantage in the minds of key stakeholders, including employees. Outside the United States, 61 percent of their global peers say the same.

What does all this imply for corporate boards? It may mean that it is time to put climate-related issues on the board agenda (if they are not there already). These discussions are most effective when integrated into a company's strategic planning sessions. In its oversight role, the board should expect management to assess climate-related risk the same as it does any other significant risk and when appropriate, to raise issues. Consider these climate-specific examples:

☐ A beverage maker wants to grow sales in emerging markets. Management has projected water requirements that match the growth plan. However, in Africa and Asia there are a number of risks that could impair the company's sustained access to potable water. Drought, competing uses, and degrading water quality are prevalent in these emerging markets. The company's board should expect that management has considered those risks and developed strategies to mitigate them.

☐ An energy company is seeking an acquisition opportunity in a foreign market. In its due diligence process, management downplays regulatory risk because pending legislation on climate change has been stalled in the country's legislature and the country's track record of enforcing environmental regulation is weak. However, environmental issues are major concerns on the part of the populace. A judge supports a number of legal environmental challenges against the company post acquisition. As the situation changes and the acquisition proves much more costly than originally expected, management determines its response and informs the board.

☐ A manufacturer of garden and lawn care products learns that its largest customer plans to give preference to suppliers that have relatively lower-carbon intensity in their products. The lawn care company had not anticipated the announcement, and must play catch-up on its emissions inventory, abatement options, and climate change positioning in the market. Several of its competitors had already been pursuing green initiatives, which in the view of management represented an unnecessary expense. The company must now make major capital commitments to lower the energy intensity of its products or risk losing its largest customer.

As these examples illustrate, management should ensure its ongoing assessments take into account the changing nature and likelihood of climate-related risks, and their potential impacts on business objectives. Directors, for their part, can position themselves to engage management most effectively by staying informed. Specifically, directors who are responsible for overseeing risk will want to:

☐ Become familiar with the range of potential climate change risks the company faces.

☐ Understand management's assessment of the specific risks that could jeopardize the company's ability to carry out its strategy and reach its objectives.

☐ Discuss management's analysis of which risks (if any) are material, and thus warrant disclosure.

Step One: Become familiar with the range of potential climate change risks facing the company.

The good news: Directors need not become experts in climate-related risk, but they should understand what kinds of climate-related issues could affect the company. While the SEC's guidance describes risks that may be more or less material for a company, the full range of potential risks could be broader depending on the company's operations and industry.

There are a number of resources available to help

Business Issues And Climate Change

Risks Vary Widely

Regulatory impacts

☐ *Regulatory compliance.* Regulatory mandates can affect companies on an international, national, or local basis. Consider that federal and state clean-air regulations stipulate increasingly stringent greenhouse gas emissions standards. Cap-and-trade systems require emitters to either reduce emissions or purchase allowances. Renewable portfolio standards now require many utilities to source a percentage (usually 10 to 20 percent) of distributed power from renewable energy.

Operational impacts

☐ *Capital commitments.* Requirements for emitters to install so-called best-available-control technology can necessitate significant capital requirements and expenditures. Similarly, modifications to power and transportation infrastructures to accommodate smart applications and electric vehicles may cause new capital needs.

☐ *Competition for water.* Scarcity of fresh water is forcing prioritization of use, with more-essential applications (such as agriculture) gaining preference.

☐ *Severe weather.* An increase in severe-weather events may shift the risk profile for insurance companies. Insurance studies show an increase in the frequency and severity of weather events since 1985. Ceres reports that weather-related losses totaled more than $200 billion in 2008 alone.

Market impacts

☐ *Technology shifts.* Pressures to improve energy efficiency and increase clean-energy use are driving technological change in all industries, and could significantly transform the automotive, electric power, and manufacturing sectors.

☐ *Rising raw-material costs.* As energy prices begin to reflect the cost of carbon, raw-material inputs beyond fuel will be affected. As an example, the cost of corn rose in response to ethanol mandates.

☐ *Demand for lower-carbon products.* Public and private initiatives are creating demand for lower-carbon products and technologies that reinforce regulatory mandates. For example, in the first quarter of 2010, Walmart announced it would reduce 20 million tons of greenhouse gas emissions in its supply chain by 2015. Separately, President Obama has ordered the federal government to reduce greenhouse gas emissions 28 percent by 2020.

☐ *Investment opportunities.* The aggregate demand for low-carbon technology will increase direct investment opportunities exponentially. Analysts PointCarbon estimate the global carbon market (wherein companies trade allowances and purchase carbon offsets) will reach $170 billion by the end of 2010. Government stimulus packages have designated nearly $400 billion for clean energy investments.

Reputational impacts

☐ *Corporate social responsibility.* Increasingly, shareholder resolutions seek action on sustainability concerns, including climate change. Investors, employees, and consumers alike want to understand how companies' environmental practices stack up against those of their competitors, including how companies are reducing the environmental impacts of the products they sell.

☐ *Corporate liability.* Companies including electric power generators, coal producers, chemical makers, and insurers are facing tort cases that seek damages under public nuisance claims related to greenhouse gas emissions.

executives and directors understand the potential range of risks. The World Resources Institute, the Pew Center on Global Climate Change, and The Conference Board are among many that provide analysis geared toward executives.

Step Two: Understand management's assessment of how climate risks could impact performance.

At companies that face significant climate-related risk, boards take different approaches in understanding management's decisions and actions. At one end of the spectrum, a board may have a separate committee devoted exclusively to overseeing environmental risks relating to climate change. At another company, the full board might periodically discuss environmental risks as part of the company's overall risk management program.

Regardless of how the board is organized, manage-

ment is responsible for identifying, assessing, and managing climate-related risks and opportunities. Typically, management first identifies significant risks by asking which risks could jeopardize the company's ability to execute its strategy and meet its business objectives. It is helpful for directors to understand which questions management finds most relevant in identifying risks and opportunities for the organization. Management's initial screening typically covers such questions as:

- Do our levels of energy and resource use help us remain competitive? Will our raw-material costs go up because suppliers are subject to regulation? If so, can we pass those costs on?
- Is demand likely to change for the products we sell because of climate regulation or growing social concern about the environment? By how much?
- What opportunities exist for our company to meet rising demand for more eco-conscious products? How does the environmental impact of the company's core products compare with that of key competitors?
- What are the current or potential regulations or legislation regarding climate change that could directly (or indirectly) affect our company?
- Are any of our assets or links in our supply chain vulnerable to severe weather? To shortages or contamination of water? To rising electricity prices?
- How are our competitors disclosing their climate-related information? What perceptions do stakeholders have of how we compare?

Our experience has been that initial climate risk discussions sometimes expose needs for different expertise and input from across (and possibly outside) the company. At first, such discussions can be rather abstract. The incipient nature of specific risks, the relative inexperience of management in assessing the issues, and uncertainty about the importance of the issues all can present challenges.

Identifying climate risks is only the first step. In the next step, management assesses them. A climate-related risk profile evaluates each specific risk's importance to the company's business objectives. Such a profile can also serve as a useful tool for actively managing risks.

To help prioritize assessments and make them more concrete, the board can set expectations about the kinds of analysis it would like from management. Those expectations can include identification of the root causes of the risks that executives have identified; an analysis of how those risks might prevent the company from achieving its business objectives; and information on how management is responding to the risks.

It is also useful to know which risks management is choosing not to mitigate, because that would reveal whether management's risk appetite aligns with the board's.

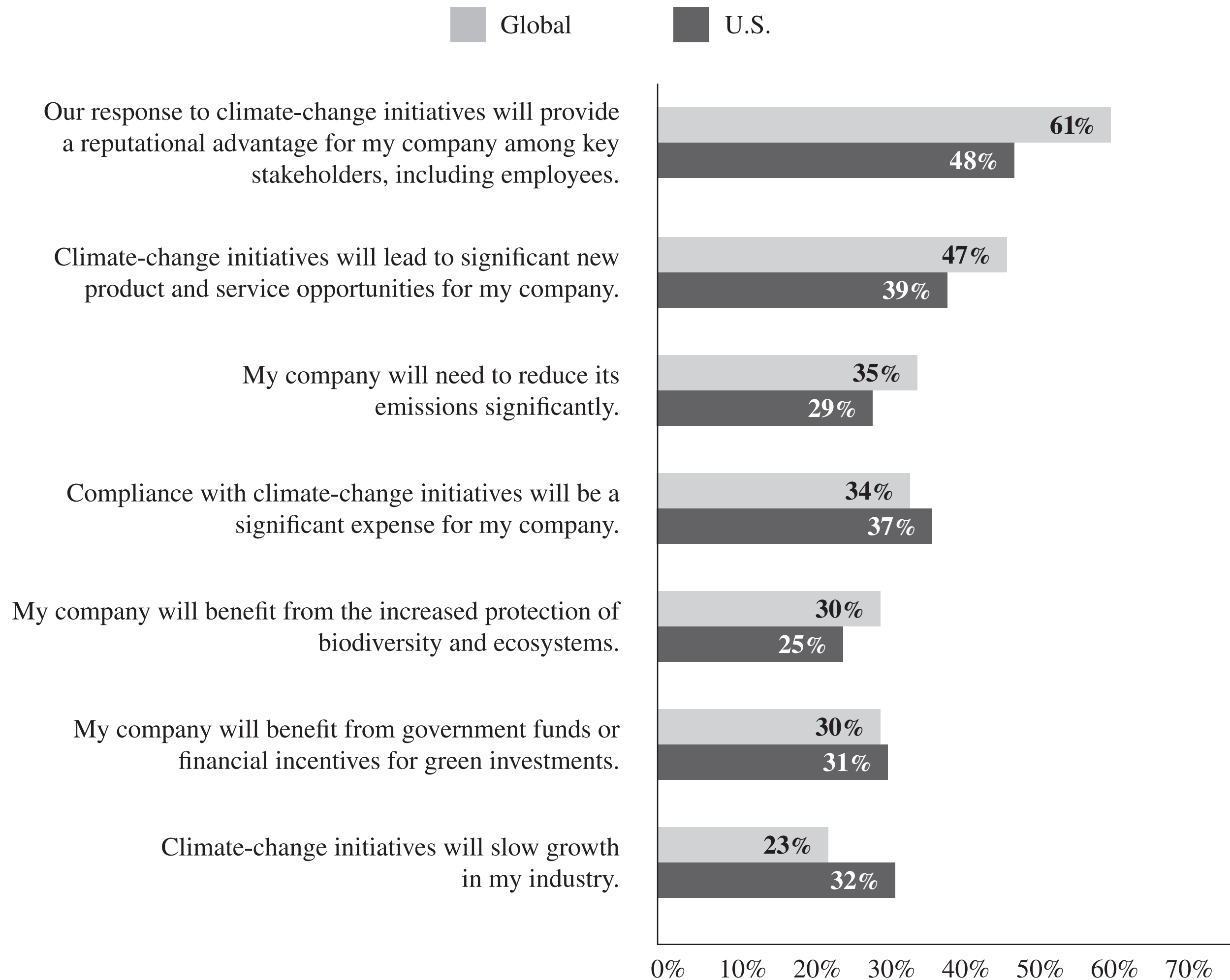
For example, consider a company that views its greenhouse gas emissions as a significant risk. Management's response to that risk might include seeking acquisitions that lower the company's carbon intensity; purchasing carbon offsets; forecasting compliance costs; and reporting its success in its corporate social responsibility report.

The board will also have views on how frequently it wants ongoing information and the degree to which management should ensure the reliability of emissions information. This depends on the nature and significance of the climate risks the company faces. If the reliability of the information on a company's greenhouse gas emissions inventory is not at acceptable levels (perhaps it cannot be independently verified), the board should expect management to address the issue.

Step Three: Recognize which risks, if any, are material and warrant disclosure.

Directors will want to understand not only the climate-related risks that could impact their company, but also which risks are material and thus warrant disclosure in regulatory filings.

A climate-related risk is material if there is substantial likelihood that a reasonable investor would consider such risk important in deciding how to vote or make an investment decision. Put another way, whether the information would alter the total mix of available information.



Directors should be reviewing any such climate-change risk disclosures called for in the SEC's new guidance as part of their typical review of key SEC filings. With that said, experienced directors know the importance of transparency. They compare draft disclosures with the nature of boardroom discussions and are not afraid to push back if they have a different view of what management should disclose.

Of course, if management has defined environmental issues as priorities, the company may already be voluntarily communicating a wide range of information. Common channels include sustainability and corporate social responsibility reports. Many companies will also participate in voluntary initiatives such as The Carbon Disclosure Project, which collects greenhouse-gas emissions data and information on

Effective Climate Risk Assessment

Keys To Success

☐ *Foresight.* Executives should assess risks before crises arise and then incorporate their assessments into strategic-planning sessions. The best risk assessments help management build a strategic platform that can differentiate the company from the competition and build distinctive value.

☐ *Subject-matter expertise and cross-functional insight.* Savvy corporations bring in environmental subject-matter expertise from outside the company if needed. If risk management is assigned to an environmental-responsibility or compliance department, they make sure that the department gathers input from across the company on climate risks and their implications.

☐ *A clear connection to business objectives.* Directors set the expectation that climate-related risks will be assessed in the context of such risks' business impact.

climate change strategies on behalf of institutional investors. If the company has published extensive information on its climate risks in such places, the board will also likely want to ask management how it ensures the consistency of the information.

Rest assured, shareholders and other stakeholders who are interested in this issue will review all available information to evaluate a company's climate-related risk profile as well as management's strategies for addressing their risks. These include voluntary disclosures, regulatory filings, and public-domain material. Any inconsistencies will draw into question the credibility of the company's disclosures on environmental issues.

Regardless of a board's view of climate change, the SEC's interpretive guidance makes clear that companies must consider the broad implications of business risks and opportunities related to climate change, including how they might affect performance. Executives will need to consider the issue in disciplined and thoughtful ways, engaging the board in their efforts and integrating the risk analyses into the strategic-planning and performance management processes.

Ultimately, a board will best position itself to guide management and fulfill its obligations to shareholders when directors understand the range of potential risks related to climate change and have confidence that management has identified and addressed those risks. ■

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